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In the Supreme Court of the United States

OCTOBER TERM, 1931

No. 349

OLD COLONY RAILROAD COMPANY, PETITIONER

v.

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The respondent does not oppose the petition.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 49–60) is reported in 18 B. T. A. 267. The opinion of the Circuit Court of Appeals (R. 73–75) is reported in 50 F. (2d) 896.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered June 10, 1931. (R. 75–76.) The peti-

tion for a writ of certiorari was filed September 3, 1931. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where the taxpayer sold its bonds at a premium prior to March 1, 1913, did the Commissioner of Internal Revenue properly reduce the amount of the deduction allowed the taxpayer on account of interest paid on these bonds during the calendar year 1921 by an amortized portion of the premium it had received?

STATUTE INVOLVED

Section 234 (a) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 254, provides as follows:

> SEC. 234 (a). That in computing net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; * * *.

STATEMENT

During the years 1895 to 1904 the petitioner issued and sold its bonds in considerable sums, receiving therefor, in addition to the face amount of the bonds, premiums aggregating $199,528.08. (R. 44.) These premiums were credited to a "premium on bond" account and remained there undisturbed until 1914, when the Interstate Commerce Commission required the petitioner to amortize these premiums over the periods of the respective lives of the bonds. For each year subsequent to 1914, the petitioner reported to the Interstate Commerce Commission a ratable proportion of these premiums as income. On its books in each such year the petitioner credited such proportion of the premiums to its profit and loss account, and not to its income account. The amount so credited to profit and loss for the year 1921 was $6,960.64. (R. 45.)

In its income-tax return for the calendar year 1921 the petitioner deducted from gross income the entire amount of interest paid on these bonds. The respondent decreased the amount of this deduction by the amount of the amortized bond premium, $6,960.64, thus increasing the petitioner's taxable income for the year 1921 by this amount. (R. 45.)

The Board of Tax Appeals, on the authority of its decision in the case of the same taxpayer for the preceding tax year (*Old Colony Railroad Co.* v. *Commissioner*, 6 B. T. A. 1025), and the affirmance

of that decision by the Circuit Court of Appeals for the First Circuit (26 F. (2d) 408), held that no part of the premiums in question could be included as part of the income of the petitioner in 1921. On a petition to review brought by the Commissioner of Internal Revenue, the decision of the Board of Tax Appeals was reversed by the Circuit Court of Appeals for the First Circuit. (R. 73–75.)

MEMORANDUM

In a previous case involving the same taxpayer, *Commissioner* v. *Old Colony R. R.*, 26 F. (2d) 408, the same Circuit Court of Appeals which decided the case at bar held that premiums received by the taxpayer upon the sale of its bonds prior to March 1, 1913, should not be amortized over the life of the bonds and a pro rata part returned as accrued income for the year 1920, the taxpayer being on the accrual basis. A petition for a writ of certiorari filed by the Commissioner was granted. (278 U. S. 592.) In this petition and in the Government's brief on the merits it was pointed out that while *in form* the Commissioner treated the amortized premiums as income for 1920, *in fact* he subtracted from the total interest payments to bondholders which were deducted from gross income the exact amount by which such interest payments had been increased by reason of premiums paid at the time the bonds were sold. But the case had not been tried on that theory in the courts below and upon

examination of the record it was found that it failed to disclose the amount of interest payments which had been deducted. Hence the Commissioner filed a motion to dismiss which was granted. (279 U. S. 876.)

The instant case relating to the year 1921 involves the same long-term bonds. The amount of interest paid to bondholders is disclosed by the record (R. 64–67) and the question presented to the Board of Tax Appeals upon motion for reconsideration to the Circuit Court of Appeals and to this Court is whether the part of the amortized premiums applicable to the year 1921 should be treated as offsetting amortized interest paid to the bondholders during that year in determining the deduction allowed under Section 234 (a) (2) of the Revenue Act of 1921 (*supra*, p. 2), which represents a payment in part of such premium. The Circuit Court of Appeals held that it should be so treated and in so doing stated that in the earlier case its attention had not been called to the fact that the premium was not being taxed but was merely being used to offset the interest deduction. (R. 74–75.)

A conflict is claimed between the decision in this case and the decision of the Circuit Court of Appeals for the Seventh Circuit in the case of *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990, in which a petition for certiorari and a brief in opposition have been filed, No. 78, October

Term, 1931. In that case, it was held *inter alia* that a pro rata part of expenses incurred in the years 1904 to 1908 in connection with the issuance and sale of certain long-term bonds could not be deducted in income-tax returns for the years 1916 to 1919, inclusive.

We believe that the question of allowing such expenses to be amortized and deducted over the life of the bonds is totally different from the question of allowing a pro rata part of amortized bond premiums to be offset against interest deductions. There is no relation between such expenses and the calculation of interest. They do not enter into the transaction between the lender and the borrower at all, whereas the premium is paid by the lender for the obligation of the taxpayer to pay a rate of interest higher than the rate at which the bonds could be sold on the market at par upon the assurance that the premiums will be repaid dollar for dollar in installments and in the form of excess interest on the face of the bonds. For taxation purposes the problem reduces itself to the matter of allowing the taxpayer to deduct so much of the interest paid to bondholders as equals the effective interest rate, the balance constituting a repayment of the premium. Thus, while the Circuit Court of Appeals in the Seventh Circuit relied upon the earlier *Old Colony Railroad Company* case in deciding the deductibility of the expenses incurred in selling bonds

prior to March 1, 1913, there is not in fact a conflict between the *Chicago, R. I. & Pacific Company* case and the case at bar. In that connection attention is called to the fact that amortization of bond discount, which is more closely analogous to bond premium, had been allowed to the *Chicago, Rock Island and Pacific Railway Company* and was not questioned. See also *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. (2d) 695 (C. C. A. 4th).

Notwithstanding the absence of a direct conflict, we feel now, as was felt when application was made for certiorari in the former *Old Colony Railroad* case, that the question is one of sufficient importance for review by this Court. In the petition filed in that case it was stated that the aggregate bonded indebtedness of American carriers who uniformly maintain a system of accrual accounting amounted to $10,811,943,274 on January 1, 1918, that most of this indebtedness was represented by long-term bonds issued either at a premium or discount, and that the effect of such premium and discount on income should be authoritatively settled. The amount of such indebtedness had increased to $11,456,596,390 as of December 31, 1930.[1] Consequently, the question is no less important now than it was at the time that the former petition was filed.

[1] Interstate Commerce Commission's Annual Report of the Statistics of Railways of the United States for the year ending December 31, 1930 (not in print September 30, 1931).

CONCLUSION

While we believe that the decision of the Circuit Court of Appeals in the instant case is correct, we do not oppose the petition.

Respectfully submitted.

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